INITIAL STATEMENT OF REASONS
FOR THE AMENDMENTS OF RULE CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner (Commissioner) sets forth below the reasons for the proposed amendments to Sections 260.231, 260.235, 260.237, 260.237.2, 260.238, and 260.241.3; the repeal of Section 260.237.1; and the adoption of Sections 260.235.5, 260.238.1, 260.238.2, 260.238.3 and 260.238.4 of Title 10 of the California Code of Regulations.

This proposed regulatory action seeks to increase uniformity with investment adviser regulation in other states, as well as with recently adopted and long-standing Securities and Exchange Commission (SEC) rules and interpretations. Most of these proposed regulations conform to the North American Securities Administrators Association (NASAA) Model Rules.

The Department of Corporations (Department) licenses and regulates investment advisers pursuant to the Corporate Securities Law of 1968, as amended (Corporate Securities Law). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate, as specified.

Section 260.231

Under the existing rules, an investment adviser must file Form ADV with the Commissioner through the Investment Adviser Registration Depository (IARD) system, an online depository shared by various securities administrators. Part II of that form may be filed in paper until the IARD system allows it to be filed electronically.

This rule is amended to incorporate the April 23, 2007, upgrade to the IARD system which allows investment advisers to submit Part 2 of Form ADV through the IARD system. Investment advisers will no longer be able to file the form in paper.

Section 260.235

The existing rule set forth various advertising practices by an investment adviser that constitute fraudulent, deceptive, or manipulative acts.

This rule is amended to incorporate principles governing performance-based advertising set forth in the 1986 SEC No-Action letter involving Clover Capital Management (Clover). The *Clover* No-Action letter involved the interpretation of Rule 206(4)-1(a)(5) (*17 CFR 275.206(4)-1(a)(5)*) of the Investment Advisers Act of 1940 (Investment Advisers Act), and more specifically addressed the use of performance advertisements. In general, the amendments prohibit performance advertisements that fail to disclose certain information to potential investors. More specifically, the amendments prohibit performance based advertisements that:

- Fail to disclose the effect of material market or economic conditions on the results advertised.

- Fail to disclose the extent to which the advertised results reflect the reinvestment of dividends or other earnings.

- Fail to disclose all material facts necessary to avoid any unwarranted inference.

- Suggest or makes claims about the potential for profit without disclosing the potential for loss.

- Omit any of the facts material to the performance figures.

- Fail to reflect the deduction of advisory fees, brokerage, or other commissions, and any other expense that a client would have paid or actually paid.

The proposed changes will increase uniformity with investment adviser regulation at the federal level by incorporating the established principles set forth in *Clover* into California Law regulating investment advisers. In addition, the amendments will increase protections for investors with regard to performance-based advertisements, which without adequate disclosures have the potential to be misleading.

Section 260.235.5

The existing rules do not do not require investment advisers to provide clients or prospective clients with written disclosures.

This rule incorporates NASAA model rule 203(b)–commonly referred to as the "Brochure Rule"–requiring disclosures to clients by investment advisers. NASAA model rule 203(b) mirrors the corresponding federal rule regarding investment adviser brochure requirements found in 17 C.F.R. 275.204-3. This rule will require investment advisers to deliver to each prospective advisory client a written disclosure statement, or brochure, describing the adviser's business practices and educational and business background. The required disclosure consists of Part II of Form ADV, the registration form for investment advisers.

By providing relevant background information on the investment adviser, the rule will enable prospective investors to make more informed decisions in the process of selecting an investment adviser.

Section 260.237

The existing rule set forth requirements for investment advisers with custody or possession of clients' funds or securities.

The amendments revise the rule to incorporate changes under federal law and changes to the NASAA Model Rules. By way of background, on September 25, 2003, the U.S. Securities & Exchange Commission (SEC) adopted amendments to the federal custody rule under the Investment Advisers Act applicable to federally registered investment advisers. However, pursuant to the National Securities Markets Improvement Act of 1996, such federal changes are not applicable to investment advisers licensed solely in state jurisdictions.

The amended SEC rules define “custody" in Rule 206(4)-2 (17 C.F.R. 275.206(4)-2). The prior NASAA Model Rules were drafted based on the predecessor federal rules that did not contain a definition of custody, and therefore the SEC’s changes to the federal custody rules required changes in the NASAA Model Rules to provide needed uniformity in this area between the regulation of federal-registered and non-federal registered investment advisers, as well as to provide equivalent levels of investor protection.

The proposed amendments to this rule strike the existing language and enact the revised NASAA Model Rule. In general, the amendments define “custody” and require that advisers with custody maintain the assets with a qualified custodian, as defined in the rule.

Additionally, the amendments require that an investment adviser have a reasonable belief that a qualified custodian holding the assets is providing periodic account statements to clients.

These amendments increase client protections by providing additional safeguard measures for client funds and securities. Additionally, the amendments provide additional guidance to investment advisers by specifically defining the term “custody” and thus providing added predictability.

Section 260.237.1

This rule is being repealed. The section became inoperative on January 1, 2005, and the current section setting forth minimum financial requirements for investment advisers is Section 260.237.2 (10 C.C.R 260.237.1).

Section 260.237.2

This rule is amended to eliminate the reference to Section 260.237.1 (10 C.C.R. 260.237.1) that became inoperative on January 1, 2005, and to strike the previous definition of custody found in subsection 260.237.2(e), and instead cross-reference the proposed definition of custody found in Section 260.237(c)(1) (10 C.C.R. 260.237).

In addition, the rule is amended to:

- Require an investment adviser with custody of client funds to maintain a positive current ratio;

- Require an investment adviser with custody or discretion over client funds to prepare a trial balance and compute the minimum financial requirements under the rule on a monthly basis;

- Clarify the information to be reported to the Commissioner upon the investment adviser's net worth or current ratio falling below that permitted by rule;

- Clarify that retirement accounts and specified loans and advances are not to be included when calculating "net worth";

- Define "net ratio" to mean current assets over current liabilities, as specified;

- Clarify that "custody" has the same meaning as Section 260.237 of the rules;

- Clarify the meaning of exercising discretion to allow for specified trading through any qualified custodian, rather than just a broker-dealer;

- Provide that the failure to maintain books and records does not relieve the investment adviser of the minimum financial requirements;

- Clarify that the failure to meet the minimum financial requirements of this rule results in reporting requirements under Section 260.241.2 of these rules; and

- Require an investment adviser to disclose deficiencies in its financial condition to its clients.

These changes are necessary to clarify the minimum financial requirements for investment advisers for the protection of investors, to ensure that deficiencies related to the maintenance of books and records are not used as a shield for noncompliance with minimum financial requirements, and to recognize that an investment adviser is not "exercising discretion" for specified trading activity through any qualified custodian, rather than just a broker-dealer.

Section 260.238

This section sets forth certain activities that do not promote "fair, equitable, or ethical principles," as that phrase is used in Section 25238 of the Financial Code. The proposed amendments add additional acts and practices that do not promote fair, equitable, or ethical principles. The purpose of the proposed amendments is to increase uniformity in state securities regulation by adopting changes to NASAA Rule 102(a)(4)-1, and to provide investors with increased protections from unfair or unethical practices.

The proposed changes would state that the following acts constitute an unethical business practice:

- Failing to adopt procedures designed to prevent the misuse of material nonpublic information.

- Requiring a client to waive protections provided by these rules.

- Engaging in any conduct unlawful under these rules.

The amendments further provide that investment advisers and investment adviser representatives are fiduciaries. The amendments will provide additional protections for investors by ensuring that investment advisers comply with their fiduciary duties, and by ensuring that certain transactions are not tainted by potential conflicts of interest on the part of the investment adviser.

Section 260.238.1

This proposed rule mirrors the Federal Investment Adviser Code of Ethics implemented by the SEC (17 CFR 275.204A-1). In general, the rule requires investment advisers to adopt procedures designed to prevent the misuse of material nonpublic information.

More specifically the rule requires the adoption of:

- A code of ethics that reflects the fiduciary obligation of the investment adviser, and its supervised persons.

- Procedures requiring supervised persons to comply with applicable federal and state securities laws.

- Procedures requiring certain employees to report personal securities transactions to the investment adviser.

Similar to the SEC rule, this rule is intended to promote compliance with fiduciary standards. This rule will provide additional protections to investors by implementing procedures that promote ethical behavior by investment advisers and their supervised employees. In addition, the rule reduces the likelihood of conflicts of interest, by requiring supervised employees to disclose personal securities transactions.

Section 260.238.2

In general, this proposed rule clarifies practices involving “soft dollars.” These practices involve obtaining certain services or goods by indirectly incorporating the charges for those services into client commissions.

This proposed rule incorporates Section 28(e) of the Securities Exchange Act of 1934 (“Securities and Exchange Act”) as further clarified by SEC Release No. 34-54165, (17 C.F.R. Part 241). In this release, the SEC interpreted the term “brokerage and research services” under Section 28(e) of the Exchange Act.

In its recent interpretation of the rule the SEC found that the “use of client commissions to pay for research and brokerage services present money managers with

significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services."

This section would adopt the safe harbor of Section 28(e) of the Exchange Act that allows money managers to use client funds to purchase "brokerage and research services" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. This section provides investors protection from practices that present significant conflicts of interest, and properly allocates certain overhead charges to the investment adviser rather than to client commissions.

Section 260.238.3

This rule largely mirrors SEC Rule 260(4)-3, commonly referred to as the "Cash Solicitation Rule" (17 C.F.R. 275.206(4)-3). In general, the SEC rule prohibits any investment adviser required to be registered under the Investment Advisers Act from paying a cash fee, directly or indirectly, to any solicitor with respect to solicitation activities if the solicitor has been found in violation of certain pertinent provisions of the Investment Advisers Act or is subject to certain SEC orders. The rule further sets forth requirements for permissible fees to be paid to solicitors.

The proposed rule incorporates much of the language of the SEC rule and permits payments to solicitors for client solicitations provided that the adviser complies with the investor protections set forth in the rule. The rule requires that the cash fee for solicitation activities must be paid pursuant to a written agreement, and also requires the solicitor to provide certain disclosures to clients regarding the terms of the agreement. Finally, an investment adviser is required to make a bona fide effort to ascertain whether the solicitor has complied with the conditions set forth in the agreement.

By providing for disclosures pertaining to the agreement between the solicitor and the adviser, the client will be able to make more informed decisions in the process of selecting an investment adviser.

Section 260.238.4

This rule requires an investment adviser to adopt and implement a business continuity plan. The plan must specify how an investment advisory business would respond to emergencies of varying scope. In general, the business plan may be tailored to the size and scope of the investment advisory business. The plan must be in writing and must specify how an investment adviser would address situations that disrupt the advisory business (e.g., alternative communications channels between an investment adviser and its clients). The plan must also provide certain specified safeguards for clients in the event of death or incapacitation of the investment adviser. For example, the investment adviser must specify how clients will be notified in the event of death or incapacitation of the investment adviser.

Finally, the investment adviser would be required to disclose the nature of the plan to clients. This rule is necessary to protect the interests and assets of clients in situations that disrupt the investment advisory business of the investment adviser.

Section 260.241.3

On May 30, 2001, the SEC made changes to its rules with regard to the preservation and maintenance of an investment adviser's books and records (17 C.F.R 275.204-2). The changes related to how records should be maintained, regardless of form (electronic or otherwise). The rule requires all records to be arranged and indexed, promptly provided to regulators upon request and separately stored from the original to a duplicate copy on any medium allowed, based on the time preservation of the original record. NASAA has also incorporated these changes into its model rule 203(a)2.

The proposed amendments to this rule mirror the NASAA model rule.

The proposed amendments:

- Require that financial statements required to be maintained under subsection (a)(6) of the rule be prepared in accordance with General Accepted Accounting Principles.

- Require that records pertaining to transactions set forth in proposed Section 260.235.6 (10 C.C.R. 260.235.6) also be maintained by the investment adviser.
- Amend subsection (a)(11), involving the retention of circulars or advertisement sent to individuals, to lower the number of persons that would trigger the retention requirement, from 10 individuals to 2 individuals.

- Require the retention of written communications involving litigation regarding a written customer complaint.

- Require the retention of information regarding clients that is the basis for making any investment recommendation to such clients.

- Require the retention of written procedures to supervise employees, to ensure their compliance with securities laws.

- Require the retention of documents of each initial Form U-4 and each amendment to the disciplinary reporting pages in Form U-4.

- Require the retention of certain specific documents, where the investment adviser inadvertently held or obtained a client's securities.

- Requires the retention of documents that grant the adviser the authority to withdraw a client's funds or securities maintained with a custodian.

- Require the retention of certain specific documents that are acquired by the investment adviser from the issuer in a transaction not involving any public offering.

- Require the retention of certain documents necessary to form the basis for calculation of the performance of all managed accounts or securities recommendations in any notice, or advertisement.

- Require the retention of certain documents in situations where an investment adviser has custody of securities or funds.

- Require the retention of documents showing what securities were purchased and sold, and amount and price of each purchase and sale.

This rule increases consistency with regard to document retention, regardless of whether the document is held in electronic form, provides consistency with federal law and the NASAA model rule, and improves investor protection by ensuring adequate records are maintained by the investment adviser.

ECONOMIC IMPACT GOVERNMENT CODE SECTION 11346.2(B)(4)

The Commissioner has made an initial determination that the proposed regulatory action for requirements will not have a significant adverse impact on business.

ALTERNATIVES CONSIDERED

The Department is not aware of any reasonable alternatives to this proposed rulemaking action for carrying out the purposes for which this action is proposed. Under Government Code Section 11342.610(b), an investment adviser is not a small business, and therefore no alternatives would lessen the impact of this rulemaking action on small business.

FISCAL IMPACT

There is no cost to local agencies and school districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

No other nondiscriminatory cost or savings are imposed on local agencies.

DETERMINATION

The Commissioner has made an initial determination that the proposed regulatory action does not have a significant adverse economic impact on business.

TECHNICAL STUDIES RELIED UPON

The Department did not rely upon any technical, theoretical, or empirical study, reports, or other similar document in proposing the adoption of this regulation.

ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that have otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the regulation is proposed, or would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small business.